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September 6, 2007

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Ms. Nancy M. Morris

Secretary

U.S. Securities and Exchange Commission

100 F Street, NE

Washington, DC 20549-1090

Dear Ms. Morris:

## **RE: File Number S7-14-07 Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934**

The Center for Audit Quality (CAQ) is an autonomous public policy organization serving investors, public company auditors and the capital markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants. We welcome the opportunity to share our views on the Securities and Exchange Commission (SEC or the Commission), File Number S7-14-07, Release Number 34-56010, Exemption of Compensatory Employee Stock Options from Registration under Section 12(g) of the Securities Exchange Act of 1934 (the SEC Proposal).

## **Accounting Implications Under SFAS 123(R)**

### *Valuation Effects of Transferability Restrictions*

As a condition of the proposed exemption from registration, Exchange Act Rule 12h-1(f)(1) would require the issuer to impose strict conditions on the stock options and the shares issuable upon exercise of those stock options. Those restrictions must prohibit the ability of the holder, with limited exceptions, to transfer, pledge, hypothecate or otherwise hedge the stock options or shares of the class of equity underlying those options. The related restrictions would be required in the issuer's by-laws, certificate of incorporation, option plan or individual option agreement.



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U.S. Securities and Exchange Commission  
Ms. Nancy Morris, Secretary  
September 6, 2007  
Page 2

The SEC Proposal indicates that these transferability restrictions are not intended to interfere with the ability of a nonpublic company to value its options for purposes of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* ("Statement No. 123R"). In our view, such restrictions generally should not affect the ability of a nonpublic company to value its stock options for purposes of Statement No. 123R. In our experience, such valuations usually presume that the holder will not exercise the stock option until the earlier of (a) the termination of employment, (b) a liquidity event involving the employer (e.g., an initial public offering or sale of the company), or (c) the expiration date of the option. That is, unlike stock options of public companies, the valuation of nonpublic company stock options generally does not contemplate that the holder will exercise the stock options in order to realize value through the sale or transfer of the underlying shares, absent a liquidity event.

As a practical matter, the proposed exemption should contemplate the potential acquisition of the nonpublic company by either a strategic or a financial buyer (i.e., a liquidity event). Many private companies do not ultimately become public companies as a result of an initial public offering (IPO) or registration under the Exchange Act. Instead, many private companies are ultimately acquired. As proposed, for options designed to satisfy the proposed exemption, it appears that the transfer restrictions would not allow the option holder to participate in an exchange transaction involving a change in control of the issuer. It seems that the objective of the exemption still would be achieved if option holders were allowed to participate in such a transaction. However, if the acquirer is also a nonpublic company, the Commission could consider requiring that the consideration for the restricted stock options (or restricted shares after exercise) be limited to options or shares of the acquirer that are subject to similar transfer restrictions.

### *Repurchase Conditions and Liability Accounting*

As proposed, notwithstanding the transferability restrictions otherwise required, the Exchange Act Rule 12h-1(f)(1)(iv) allows that "the optionholder or holder of shares may transfer the options or shares to the issuer (or its designated affiliate if the issuer is unable to repurchase the options or shares) if applicable law prohibits a restriction on transfer." As drafted, the rule appears merely to allow the options and underlying shares to be puttable to the issuer if applicable state laws do not otherwise permit the issuer to impose the proposed transfer restrictions.